No. 21795-A

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

Margaret C. Lowthian,

Petitioner,

vs.

Commissioner of Internal Revenue,

Respondent.

PETITIONER'S OPENING BRIEF.

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PETITIONER'S OPENING BRIEF.

Jurisdiction.

This is a petition to review a decision of the Tax Court of the United States determining deficiencies in petitioner's Federal income tax liability for the calendar years 1956, 1957, 1958 and 1960.

Having received a notice of deficiency from respondent, petitioner, on October 19, 1964, filed her petition for redetermination with the Tax Court of the United States (Document No. 5; Tax Court General Docket No. 5182-64, p. 1). On December 30, 1966, the Tax Court entered its Memorandum Findings of Fact and Opinion (Document No. 34; reported at 25 TCM 1473, T.C. Memo 1966-283), and its Decision (Document No. 36), sustaining the deficiencies. (Tax Court General Docket, p. 3.) The jurisdiction of the Tax Court was based upon Sections 6213 and 7442 of the Internal Revenue Code. (United States Code, Title 26, Secs. 6213 and 7442.)

Petitioner filed her petition for review by this Honorable Court on March 29, 1967. (Document No. 41, Tax Court General Docket, p. 3.) The jurisdiction of this Court is based upon Sections 7482 and 7483 of the Internal Revenue Code. (United States Code, Title 26, Secs. 7482 and 7483.)

Statement of the Case.

The principal issue below was whether gain from a sale admittedly realized by petitioner was properly reported as long-term capital gain, or whether, as respondent determined, such gain should be taxed to petitioner as ordinary income.

An alternative issue below was whether respondent abused his discretion in permitting a reopening of the audit of petitioner's return for the taxable year 1956, the first year in controversy, more than three-and-one-half years after his agents had, in 1957, examined and accepted the return as filed.

On this petition for review petitioner urges that the gain did constitute capital gain and was taxable as such; furthermore, that respondent did in fact abuse his discretion, as alleged in the Court below; and that the Tax Court erred in its decision to the contrary on both issues.

The gain in controversy resulted from the following transaction:

Petitioner, a single woman, was a limited partner in a partnership known as Sam Berger Investment Company (referred to herein as "SBIC"), having an 8 percent interest as such limited partner. [TC 2, 11; this and other references to "TC" herein are to pages of the

Tax Court's Memorandum Findings of Fact and Opinion, Document No. 34.]

The limited partnership was organized on August 6, 1954, the partners and their respective interests being as follows [Ex. 15]:

General Partners	*Percentage Interest*
Eugene L. Freeland	32%
Sam Berger	20%
Limited Partners	
Lake Murray Trust No. 1	20%
HAB Trust, c/o Sam Berger	10%
MPB Trust, c/o Sam Berger	10%
Margaret Lowthian	8%

On or about November 26, 1956, petitioner sold her 8 percent limited partnership interest in SBIC for the sum of $220,000.00, which she received in installments during the ensuing years, including the taxable years in controversy. [TC 18; Stip. of Facts, para. 32, Document No. 22.] As stated above, petitioner reported gain from the sale as long-term capital gain and elected to use the installment basis.

Petitioner for many years had been and during the years in controversy was Eugene L. Freeland's secretary. Freeland was and had been a full-time civil and structural engineer. [TC 3.] As shown above, Freeland was one of the two general partners of the SBIC limited partnership, owning a 32 percent interest therein. He also sold his interest in the partnership at the same time petitioner sold her interest. [TC 18.] Respondent determined that his gain, likewise, was taxable as ordinary income. Petitioner's case and Freeland's case

were consolidated for trial in the Tax Court. Without explanation or elaboration the Tax Court stated in its Findings of Fact [TC 3]:

> "* * * The tax treatment accorded to Freeland will control with respect to the tax treatment of the transactions as far as Lowthian [petitioner] is concerned."

The general rule in Section 741 of the Internal Revenue Code provides for capital gain treatment upon the sale of a partnership interest, as follows:

> "Sec. 741. Recognition and Character of Gain or Loss on Sale or Exchange.
>
> "In the case of a sale or exchange of an interest in a partnership, gain or loss shall be recognized to the transferor partner. Such gain or loss shall be considered as gain or loss from the sale or exchange of a capital asset, except as otherwise provided in section 751 (relating to unrealized receivables and inventory items which have appreciated substantially in value)."

The exception in Section 751 is as follows:

> "Sec. 751. Unrealized Receivables and Inventory Items.
>
> "(a) Sale or Exchange of Interest in Partnership.—The amount of any money, or the fair market value of any property, received by a transferor partner in exchange for all or a part of his interest in the partnership attributable to—
>
> (1) unrealized receivables of the partnership, or
>
> (2) inventory items of the partnership which have appreciated substantially in value,

shall be considered as an amount realized from the sale or exchange of property other than a capital asset.

* * *

"(d) Inventory Items Which Have Appreciated Substantially in Value—

* * *

(2) Inventory Items—For purposes of this subchapter the term 'inventory items' means—

(A) property of the partnership of the kind described in section 1221 (1).

* * *

Property described in Section 1221(1) is—

"(1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;"

Hence, the basic issue here is whether the property of the limited partnership was, at the time of the sale by petitioner of her partnership interest, "held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

The important facts bearing upon this issue are as follows:

The limited partnership SBIC was organized on August 6, 1954 for the specific purpose of purchasing, and it did in fact purchase, approximately 4,500 acres of land known as the Waring Ranch, which had been annexed to the City of San Diego, California, in December 1953. [TC 5.] The purchase price was $4,-

676,666.66, payable $100,000.00 down and the balance in 20 annual installments. [TC 6.] Freeland provided $70,000.00 and Berger provided $30,000.00 of the money used for the down payment. [TC 7.] The purchase escrow agreement contained provisions for the release of 150 acres against each annual payment, and for the deposit of $200,000.00 by the purchaser for off-site improvements upon instructions from the seller. [TC 6.]

Berger was a real estate developer. [TC 5.] His associates in other real estate developments, referred to by the Tax Court as the "Barenfeld-Glaser Group", put up the $200,000.00 for the required off-site improvements and in return received (1) a 20 percent interest in the SBIC limited partnership (taken in the name of "Lake Murray Trust No. 1", as shown in the above statement of partners) and (2) an option to buy 500 acres of the 4,500-acre Waring Ranch then being purchased by the SBIC limited partnership. [TC 8-9.]

This 500-acre option was actually taken in the name of a newly-organized corporation known as Lake Murray Development Company (referred to herein as LMDC, as it was referred to by the Tax Court), the capital of which was furnished by the Barenfeld-Glaser Group and of which Berger was president and prime mover. Its purpose was to subdivide and develop land and construct homes thereon. Neither Freeland nor petitioner was an officer, director, stockholder or investor in LMDC. [TC 9.]

On November 4, 1954, LMDC purchased 3.19 acres by a partial exercise of its 500-acre option and constructed 7 model homes thereon. It also installed the off-site improvements. [TC 14.] In July and August

1955, LMDC purchased an additional 146.93 acres in partial exercise of its option. [TC 16.] LMDC constructed a total of 196 homes. [TC 17.]

The Tax Court found as follows:

1. "In December 1954 or January 1955, a series of disputes arose between SBIC and LMDC." [TC 16.]
2. ". . . By the summer of 1955, LMDC developed financial difficulties." [TC 17.]
3. "Ultimately, LMDC was unable to overcome its financial difficulties. It became insolvent on May 4, 1965. LMDC assigned to Phoenix Insurance Company of Hartford all of its assets, except that it retained the right under the amended option agreement to purchase 200 acres of land out of the 500 acres originally covered by the option. Since LMDC had already exercised its option to the extent of approximately 150 acres, the portion of the option assigned to Phoenix only covered the right to purchase the remaining approximately 150 acres. Phoenix subsequently exercised this option." [TC 17-18.]
4. "Berger was blamed for mismanagement of LMDC and was himself in financial difficulty." [TC 18.]

Carlos Tavares, one of the most successful land developers in the San Diego area, hearing of Berger's financial difficulties, offered to purchase Berger's partnership interest. On August 10, 1956, Berger sold to Tavares his partnership interest in SBIC, together with the interests of the HAB Trust and the MPB Trust, a total of 40 percent interest in the SBIC partnership,

for $950,000.00. Berger did not obtain Freeland's consent to such sale, as required by the SBIC partnership agreement. [TC 18.]

Tavares then approached Freeland in an effort to have him join in development of the land, which Freeland refused. Tavares then sought to purchase Freeland's and petitioner's interests. Finally, on or about November 26, 1956, Freeland and petitioner sold their partnership interests in SBIC to Tavares. [TC 18.]

The SBIC partnership never purchased any real property other than the 4,500 acre Waring Ranch. Its only sales of real property were the 150 acres to LMDC and 150 acres to Phoenix Insurance Company, both under the 500-acre option, granted at the time SBIC acquired the property, the sale of a fractional acre to the telephone company, and the sale of 4 acres to the City of San Diego for a reservoir site as required by the seller when SBIC purchased the land. [TC 20.]

The Tax Court specifically found:

1. "Freeland did not wish directly to engage in subdividing and developing the land, either individually or through any other business form, because it would place him in competition with his clients and those of his engineering partnership and thus be financially injurious." [TC 19.]
2. "At no time material hereto was either Freeland or Lowthian individually a dealer in real estate or individually holding real estate for sale to customers in the ordinary course of business." [TC 19.]
3. ". . . SBIC itself never directly advertised, promoted, or otherwise engaged in active efforts to

solicit for its land, nor did it authorize anyone to undertake such activities directly on its behalf." [TC 19.]

Notwithstanding all the foregoing, the Tax Court made a so-called ultimate finding, that SBIC held the land in question primarily for sale to customers in the ordinary course of its trade or business. [TC 21.]

The taxes reported on the 1956 returns of Freeland and petitioner Lowthian were $59,582.95 and $4,085.34, respectively. The deficiencies for the year 1956 were $93,332.32 and $10,231.29, respectively, the major portion of such deficiencies being attributable to the gain from the sales at issue in this case. [TC 20.]

During 1957, Internal Revenue Agent George Colling was assigned to audit the 1956 returns of Freeland and Lowthian. Colling specifically questioned the propriety of capital gain treatment of the sale of their respective interests in SBIC. SBIC's books and records were examined, as were many official city records. Colling concluded that Freeland and Lowthian correctly reported the gain from the sale of their respective partnership interests as capital gain. On September 19, 1958, the District Director of Internal Revenue sent letters to Freeland and Lowthian accepting their 1956 returns, subject to adjustments not material herein. [TC 21.]

On April 26, 1962, the District director approved the re-opening of petitioner's 1956 year "due to the amount of money involved and in the interest of being consistent" with the cases of the other partners in SBIC handled by another agent. On July 29, 1964, respondent issued his statutory notices herein asserting that

the sale of the partnership interests resulted in ordinary income. The period of limitations had been extended beyond that date by appropriate consents executed by Freeland and Lowthian. [TC 21.]

Specification of Errors.

1. The Tax Court erred in its conclusion that the plans of SBIC at the time of acquisition of its property continued to govern its subsequent activities, and in its conclusion that there was no change in purpose in the holding of its property. Such conclusions are not supported by its findings, but are contrary to its findings, are without support in the evidence, and are clearly erroneous.

2. The Tax Court erred in applying an erroneous legal concept in finding or concluding that SBIC held property primarily for sale to customers in the ordinary course of trade or business because of alleged "concealed participation" of some of the SBIC partners through a screen and because of alleged "interlocking participation" of some of the partners of SBIC with LMDC.

(a) If there ever had been any "concealed participation" or "interlocking participation" such participation had completely disintegrated and ceased to exist long prior to the sale of petitioner's limited partnership interest in SBIC.

(b) Insofar as petitioner Margaret C. Lowthian is concerned, there never was and never had been any "concealed participation" or "interlocking participation" by her in any other organization, and hence in any event the Tax Court's legal concept could have no application to petitioner Margaret C. Lowthian.

3. The Tax Court erred in holding that the property of SBIC was held primarily for sale to customers at the time petitioner sold her partnership interest in SBIC.

4. The Tax Court erred in imputing to petitioner Margaret C. Lowthian the intentions of others, and in refusing to follow the decision of this Honorable Court in *United States v. Rosebrook* (C.A. 9, 1963), 318 F. 2d 316.

5. The Respondent abused his administrative discretion in reopening petitioner's income tax return for 1956 after it had been audited and accepted as filed.

Summary of Argument.

I. In deciding this case the Tax Court ignored the "normal criteria" generally used as tests in cases involving the present issue, such as frequency and continuity of sales, advertising, solicitation, development, etc. SBIC did none of these things; and in fact made no sales during the more than two years it held the property, other than the two sales under the option already in existence when it acquired the land. Although conceding that SBIC did not intend to develop the land itself, the Tax Court develops what seems to be a new legal concept, of imputing a motive to the partnership based upon alleged "concealed participation" or "interlocking relationships." Petitioner submits that such concept is without merit; it fails to establish the fact that *the partnership* held the raw land for sale to customers in the ordinary course of *its* trade or business, which is the crucial question here; indeed it fails to establish that the *partnership itself* was ever in any such business, the evidence and the Tax Court's findings re-

vealing that it was not. Moreover, if such "concealed participation" did exist at the beginning, the plans had completely disintegrated long prior to the sales of partnership interests in question here, and were not germane to the purpose of the holding at the time of the sales. And, finally, there was no such "concealed participation" or "interlocking relationships" insofar as petitioner Margaret C. Lowthian was concerned, at any time.

II. The Commissioner abused his discretion under his own Revenue Procedure, when he reopened petitioner's 1956 income tax return audit. The interpretation of such Revenue Procedure adopted by the Tax Court is a strained and unreasonable one, which would practically deprive the administrative policy of any meaning or effect for taxpayers in general.

ARGUMENT.

I.

The Tax Court Refused to Apply the Normal Criteria in Deciding This Case, and Its Conclusion That the Property Was Held Primarily for Sale to Customers in the Ordinary Course of Trade or Business Is Clearly Erroneous.

The Tax Court decided this case by ignoring the "normal criteria" usually applied in determining whether real property is or is not held primarily for sale to customers in the ordinary course of trade or business. These "normal criteria" are the frequency and continuity of sales, the soliciting of sales, advertising, improving or developing the property for sale, etc.

The partnership SBIC did absolutely none of these things.

Instead, the Tax Court sought to construct a pattern of "concealed participation" or "indirect" involvement, or "interlocking relationship." Thus, we quote from its own findings and opinion:

> "The normal criteria are not the exclusive benchmarks for decision in a case such as this, where there were good reasons for indirect as opposed to direct participation in development activities and where the period of gestation was prematurely cut short." [TC 33.]
>
> "Freeland's unwillingness to join Tavares in active development does no more than confirm his unwillingness to engage in *open* competition with clients of his engineering partnership. It does not operate to erase a pattern of *concealed* participation in development through an appropriate screen such as LMBC." [TC 28.]

"We think it clear that SBIC did not itself intend to develop the 4,500 acres—such action would have been damaging to Freeland's professional activities and those of his engineering partnership." [TC 26.]

"We think the answer to the question of the role which SBIC or its principal partners was to play in development lies in the plans and operations of LMDC and its arrangements with SBIC." [TC 29.]

"It is apparent to us, however, that Berger and the Barenfeld-Glaser Group, all of whom were partners in SBIC, had substantial interests in LMDC although the precise extent of these interests was never established. These interlocking participations provided the real guarantee that the option would be exercised." [TC 29-30.]

"In this connection, we note that, while Freeland did not have an ownership participation in LMDC, he could reap his financial reward from that entity via direct personal engineering fees and fees paid to his engineering partnership." [TC 31.]

Thus, it is crystal clear that the Tax Court did not really decide that the partnership SBIC held its property primarily for sale to customers in the ordinary course of trade or business. Its findings repudiate any such conclusion. What the Court really decided was that since certain of its partners were also interested in and would benefit from the development of the properties by another entity, the partnership should be deemed to have a purpose which it really did not have. This, we submit, is a wholly erroneous interpretation of the statute.

It is understandable why the income derived by a merchant from the day-to-day sale of his inventory or stock in trade should be taxed as ordinary income. It *is* ordinary income. But certainly that is a far cry from the acquisition of a parcel of raw land by a partnership, which makes not a single sale except under an option existing when it acquired the land, which holds the land for more than two years and makes no development or attempt to make any sales, and which in fact rejects all offers to buy.

It is inconceivable that a partnership could be held to hold property primarily for sale to customers in the ordinary course of its trade or business where it makes no such sale in a two-year period. But, as we have said, the Tax Court really did not so hold. It was looking to a so-called "interlocking" relationship with LMDC.

The significant fact is that, even assuming such "interlocking" relation existed at the outset, it had completely disintegrated and ceased to exist long before the sale of petitioner's partnership interest. LMDC had been a complete financial failure and had gone out of business. In financial straits, Berger had then sold his and related 40 percent interests in the SBIC partnership.

What, then, was the purpose for which SBIC held its property?

Tavares wanted to develop the property. Freeland refused.

In that posture, how can it possibly be concluded that the property of SBIC was held primarily for sale to customers in the ordinary course of trade or business? The answer, we submit, is obvious. It simply was not so held.

Having come to an impasse, the solution was to liquidate the investment—which is exactly what petitioner and Freeland did by selling their partnership interests. But this was a liquidation of their investment, not profit attributable to the day-to-day operation of merchants trading in inventory or stock in trade.

The most recent case in which this Court has been called upon to reverse the Tax Court for failure to apply the proper legal concepts in deciding whether real property is held for sale to customers in the ordinary course of trade or business is *Joan E. Heller Trust v. Comm.* (C.A. 9, August 25, 1967), ... F. 2d ...., in which this Court gave expression to the principles announced by the United States Supreme Court in *Malat v. Riddell,* 383 U.S. 569, 86 S. Ct. 1030, 16 L. Ed. 2d 102, quoting from its opinion as follows:

> "The purpose of the statutory provision with which we deal is to differentiate between the 'profits and losses arising from the everyday operation of a business' on the one hand (Corn Products Refining Co. v. Commissioner of Internal Revenue, 350 U.S. 46, 52, 76 S. Ct. 20, 24, 100 L. Ed. 29) and the 'realization of appreciation in value accrued over a substantial period of time' on the other. (Commissioner of Internal Revenue v. Gillette Motor Transport, Inc., 364 U.S. 130, 134, 80 S. Ct. 1497, 1500, 4 L. Ed. 2d 1617)."

The findings of the Tax Court [TC 4] and the deposition of Tavares (Document No. 33, p. 14) are conclusive that the profit realized by petitioner upon the sale of her partnership interest was attributable to appreciation in the value of the San Diego land—and not to any day-to-day dealing in real estate.

II.

Petitioner Margaret C. Lowthian Was Not a Party to Any Concealed Participation or Interlocking Relationship and Hence Any Imputation of Motive to Her Was Erroneous.

Despite all the foregoing, it is abundantly clear that as to petitioner Margaret C. Lowthian there was no "concealed participation" or "interlocking participation" and hence any imputation of motives is entirely unwarranted. In this respect the case is similar to *United States v. Rosebrook* (C.A. 9, 1963), 318 F. 2d 316.

In that case the taxpayer, by and through her father, had acquired an undivided one percent interest in a tract of land on the San Francisco peninsula, which interest had been committed to a joint venture for development by a corporate entity. The principal joint venturers were interested in a development company to which the land was sold. The Internal Revenue Service insisted that the purpose of the other joint venturers must be attributed to her, as a matter of law. But this Court held to the contrary, saying:

> "* * * The able District Judge in a well-reasoned opinion pointed out that not all participants in a joint venture need have the same intent and purpose. * * *"
>
> * * *
>
> "We do not believe that the making of an investment by a trustee in a joint venture irrevocably imputes to the beneficiary of the trust the intentions of the managers of the venture regardless of when the trust property is removed from the venture."

We respectfully submit that in the present case there is no evidence whatsoever of any participation by petitioner Margaret C. Lowthian in any "concealed participation" or "interlocking participation" with any other entity. Hence, as to her there is no basis whatever for the Tax Court's conclusion. She simply had an investment as a limited partner in the SBIC partnership which, itself, did not hold property primarily for sale to customers in the ordinary course of its trade or business. She merely sold her interest in that partnership.

Her gain upon the sale of her partnership interest was accordingly a capital gain.

III.

The Respondent Abused His Administrative Discretion in Re-Opening Petitioner's Income Tax Return for 1956 After It Had Been Audited and Accepted as Filed.

Petitioners' 1956 years were apparently re-opened by respondent under the authority of Rev. Proc. 59-25, 1959-2 C.B. 938, which states, in part:

> "It is the administrative practice of the Internal Revenue Service not to reopen cases previously closed by the District Director unless there has been substantial error, both in amount and in relation to the total tax liability, or there is evidence of fraud, malfeasance, collusion, concealment or the misrepresentation of a material fact."

Respondent has never indicated that the ground for re-opening these cases was either fraud, malfeasance, collusion, concealment or the misrepresentation of a material fact, and the Tax Court held that none of these

was present. [TC 36.] Hence, the ground for re-opening under Rev. Proc. 59-25 must be "substantial error."

The Revenue Agent who audited petitioner's 1956 year was possessed of all the facts, documents, and other data he needed to make his determination. Thereafter, on September 19, 1958, the District Director sustained his judgment and closed petitioner's 1956 year. At no time during the trial of these cases did respondent introduce any evidence that had not been considered by the Revenue Agent during the course of his audit of petitioner's 1956 returns.

As a result of having re-opened petitioner's 1956 year, petitioners have been subject to the stress and expense of defending themselves against the assertion of large deficiencies from a transaction that was clearly a capital gain in 1956 and which respondent accepted as such in 1958. Additionally, respondent's dilatory processing of these cases has subjected petitioners to the burden of paying the tremendous interest on the asserted deficiencies, some 60 percent for the re-opened year of the transaction in issue.

For these reasons we submit that respondent abused his discretion under Rev. Proc. 59-25 by re-opening petitioner's 1956 year.

The Tax Court held that "substantial error" has reference only to the dollar amounts involved. This, we submit, is an erroneous interpretation. The crucial word, in petitioner's view, is the word "error." On most income tax returns of any complexity there may easily be items upon which opinions or judgments of individual Agents or Reviewers might conceivably vary. The instant case is an example in point. The first

Agent was of the opinion that the transaction was correctly reported as capital gain. The second Agent took the opposite view. Under the Tax Court's determination every return would be subject to re-opening just depending upon different opinions of Agents as long as the dollar amount was substantial enough.

This, we submit, would be a meaningless policy or administrative practice, and would afford slight repose to taxpayers generally.

We submit that the correct interpretation is that in cases of an admitted error—such as an inadvertent omission of an item of income or the claiming of a deduction in error—such cases may be re-opened if they are substantial both in amount and in relation to the total tax liability.

Conclusion.

The Tax Court's decision should accordingly be reversed.

Respectfully submitted,

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John B. Gregory,
Attorneys for Petitioner.

Certificate.

I certify that, in the preparation of this brief, I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit and that, in my opionion, the foregoing brief is in full compliance with those rules.

Adam Y. Bennion